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Trade Policy

Free Trade with Mexico:

What Form Should It Take?

edited by

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and
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Freer trade in North America could take several forms. One possibility is the creation of a trilateral free trade agreement between Canada, the United States, and Mexico, through extending the existing Canada-U.S. agreement to Mexico.

Another, somewhat separate option is the negotiation of a pair of bilateral agreements — one between Canada and Mexico, and another between the United States and Mexico.

A third possibility is a bilateral agreement between the United States and Mexico without any liberalization of trade between Canada and Mexico. This arrangement is often referred to as a "hub-and-spoke" system, in which the United States, as the hub country, benefits from preferential access to the markets of the spokes — Canada and Mexico — who do not have free trade with each other.

As the wide-ranging discussion by a group of Canadian, U.S., and Mexican observers of trade policy presented in this *Commentary* suggests, experts are divided as to the relative merits of these arrangements for the countries involved and for the global trading system generally. Debate also continues on the ways in which each of these approaches might be implemented in practice.

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Preface

On October 22, 1990, a roundtable discussion was held at the International Club in Washington, D.C. on the economic aspects of potential North American free trade arrangements. The meeting was organized and sponsored by the C.D. Howe Institute, Toronto, and the National Planning Association (NPA), Washington.

Freer trade in North America could take several forms. One option would be to create a trilateral free trade agreement between the United States, Canada, and Mexico by extending the existing Canada-U.S. Free Trade Agreement to include Mexico. A similar, but not identical, option would be for Canada and the United States each to negotiate a separate bilateral agreement with Mexico. In either case, the result would be three-way free trade plus certain special bilateral provisions.

A third, more limited possibility would just be for the United States and Mexico to reach a separate bilateral agreement to exist alongside the present Canada-U.S. bilateral. In this case, trading arrangements in North America could be described as a "hub-and-spoke" system. There would be two bilateral free trade agreements overlapping in the United States. The United States would have free trade with both Canada and Mexico, while Mexico and Canada would not have free trade with each other. In this case, the United States would be the hub country, while Canada and Mexico would be the spokes.

One purpose of the meeting was to address the question of the relative merits of the hub-and-spoke system compared with a broader trilateral free trade area. To initiate the discussion, a paper by Ronald J. Wonnacott (*U.S. Hub-and-Spoke Bilaterals and the Multilateral Trading System*, C.D. Howe Institute Commentary 23 [Toronto: C.D. Howe Institute, October 1990]) had been circulated to the participants for their comments. Some of the propositions put forward in that paper are briefly summarized in the Introduction that follows the Preface. This *Commentary* is an edited version of the roundtable discussion of this and other related topics. For reasons of space, not all comments could be included.

Thomas E. Kierans of the C.D. Howe Institute and Ed Masters of the NPA acted as co-hosts of the meeting, while Jonathan Lemco of the NPA played a key role in its overall organization. Other participants included: Richard Belous (NPA); José Luis Bernal (Economic Counsellor, Embassy of Mexico, Washington); Robert Dunn (George Washington University); Anne O. Krueger (Duke University); Robert Z. Lawrence (The Brookings Institution); Nora Lustig (also of Brookings); Peter Morici (University of Maine, Orono); Gordon Ritchie (former deputy trade negotiator for Canada in the Canada-U.S. free trade negotiations, now of Strategico Inc., Ottawa); Frances Ruzicka (Office of the United States Trade Representative); Jeffrey Schott (Institute for International Economics, Washington, D.C.); Sidney Weintraub (University of Texas, Austin); Arlene Wilson (Congressional Research Service, Library of Congress); and Paul Wonnacott (University of Maryland).

We are grateful to the participants for their assistance in editing their remarks.

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Introduction

Professor Ronald J. Wonnacott
(University of Western Ontario):

How will free trade negotiations with Mexico change trade relations in the Americas? If a tripartite negotiation expands the 1989 Canada-U.S. Free Trade Agreement (FTA) to include Mexico (with certain exceptional provisions), each country would trade freely with all of the others. Alternatively, if Canada does not participate, the result would be a Mexico-U.S. bilateral agreement creating a "hub-and-spoke" system, with the U.S. hub having separate bilateral agreements with two spokes, Canada and Mexico. Other countries could possibly be added to this at a later date through further U.S. bilateral negotiations. The result can be visualized as a rimless, multi-spoke wheel centered on the U.S. hub; the wheel is rimless because there would be no free trade agreements linking together spoke countries such as Mexico and Canada.

From an economic and political point of view, a hub-and-spoke system has quite different characteristics from an expanding free trade area. Accordingly, before allowing such a system to develop — perhaps inadvertently — it is critical to examine its effects.

Effects on Each U.S. Partner

Under the standard assumptions made throughout this discussion, each U.S. partner, such as Canada, could expect to acquire substantial gains when it signs its agreement giving it free trade with the United States; such benefits would follow in either an expanding FTA or a hub-and-spoke. The big difference occurs when new partners, such as Mexico, are added. In an expanding FTA, existing partner Canada could expect further gains from trade from such additions. Under a hub-and-spoke, however, it could expect losses.

To illustrate, if the United States, with its Canadian bilateral now in place, goes on to sign a hub-and-spoke bilateral agreement with Mexico, Canada would not get the FTA benefits of free access to Mexican markets. Instead, Canada would get worse access because of the discrimination in the Mexican market it would have to face in competition with the United States. Moreover, Canada would not get the FTA benefits of less expensive Mexican inputs that would make its industry more competitive in world markets. Instead, it would have to face stronger competition in North America and elsewhere from a U.S. industry that would be acquiring low-cost Mexican inputs.

The key difference in the two regimes is that Canada and Mexico would trade freely in an FTA, but they would not in a hub-and-spoke. This may not seem critical now, with Canadian-Mexican trade being so small (see Table 1). But given the potential for growth in Mexico, the long-run effects could be significant. Moreover, by leaving the partners in a weakened competitive position relative to the United States, a hub-and-spoke system would leave Canada, Mexico, and any future spokes at a disadvantage where it matters most — in the U.S. market, where most of the competitive story will be played out.

It is true that a hub-and-spoke system, with its separate bilateral agreements, offers one apparent advantage to a prospective spoke country such as Mexico: its own bilateral with the United States may be tailored to its special concerns. In the long run, however, setting such a precedent may be damaging to Mexico, since future U.S. bilaterals with new spokes — for example, Brazil — may be tailored at the expense of existing spokes such as Mexico.

Countries outside the hub-and-spoke system would still have an incentive to join it, even if they recognize the problems it would raise. The reason is that the new spoke's decision would give it the benefits of free trade with the United States. If it says yes, it would get these benefits; if it says no, it would not. Its decision would have little influence over the United States as it adds spokes and thus leaves the

Table 1
Trade in North America, 1989
(as a percentage of total exports/imports)

Mexico:	exports to United States	63.3%
	imports from United States	67.0
	exports to Canada	2.4
	imports from Canada	1.8
United States:	exports to Canada	21.5
	imports from Canada	18.1
	exports to Mexico	6.9
	imports from Mexico	5.6
Canada:	exports to United States	70.7
	imports from United States	63.6
	exports to Mexico	0.4
	imports from Mexico	1.3

Source: International Monetary Fund, *Direction of Trade Statistics, Yearbook 1990*.

trading system carved up in a preferential network. Thus, the new partner would have to face the costs of U.S. bilaterals with *other* countries regardless. The only decision for that country would be whether it would want its *own* free trade bilateral with the United States or not, and the answer to that — in terms of the economic issues discussed here — would likely be yes.

Effects on the United States

In an expanding FTA, the United States could expect benefits as each new partner is added. But it would benefit even more from a hub-and-spoke regime because it would also receive the benefits from the preference it would get in each spoke market in competition with other spokes. Thus, compared with an FTA, a hub-and-spoke would provide the United States with benefits at the expense of its partners. Moreover, by leaving more trade restrictions in place, a hub-and-spoke system can be expected to be less efficient than an expanding FTA; in these circumstances, special U.S. gains from a hub-and-spoke regime would be more than offset by its partners' losses.

Accordingly, one of the most substantial disadvantages to the United States of a hub-and-spoke system is that it would be perceived by its partners as a way in which the United States, already the dominant player in the hemisphere because of its income and location, would be seeking to further increase its economic dominance by allowing a preferential trading system to develop at its partners' expense. This system could also be seen as an attempt by the United States to extend its political hegemony in the Americas. Many voices are already claiming that even past nondiscriminatory trade has allowed the United States to exploit other nations in the hemisphere. A hub-and-spoke system would provide these charges with a legitimacy that they do not now have.

A further disadvantage for the United States is that a hub-and-spoke could develop into an almost byzantine network of inconsistent bilaterals, with the trade distortions and inefficiencies this implies. (Even a completely consistent set of bilaterals would involve inefficiencies not present in an FTA, and inconsistencies among bilaterals would add to this problem.) Such a system would generate lower collective levels of real income for the participating countries. Lower levels of growth in the Americas could eventually reduce the United States' growth potential as well.

Another problem with a hub-and-spoke regime is this: What happens if there were to

Table 2
Foreign Direct Investment in Mexico, 1989
(US$ millions)

Source	Flows of investment		Stock of investment	
United States	$1,733.3	72.2%	16,649.5	63.0%
Switzerland	171.0	7.1	855.3	3.2
West Germany	78.2	3.3	1,660.0	6.3
France	48.6	2.0	802.9	3.0
Netherlands and Belgium	44.4	1.8	261.9	1.0
Canada	44.5	1.9	353.4	1.3
United Kingdom	41.6	1.7	1,809.8	6.8
Spain	40.6	1.7	1,245.6	4.7
Japan	22.9	1.0	1,333.0	5.0
Others	176.1	7.4	1,476.3	5.6
Total	*2,402.2*	*100.0*	*26,447.7*	*100.0*

Source: México, Comisión Nacional de Inversiones Extranjeras.

be more applicants for a U.S. bilateral than U.S. negotiating resources could accommodate? The United States would then be forced to discriminate — in saying yes to some countries, no to others — in offering a negotiation that would itself be discriminatory.

Finally, a hub-and-spoke regime could weaken the prospects for worldwide trade liberalization because the United States, the major promoter and supporter of multilateral free trade, would have a reduced incentive to push in this direction, since it would strip away the preferential benefits the United States would get from a hub-and-spoke system. (This reduced incentive is a problem even in an FTA, but a much greater one in a hub-and-spoke system.) This raises the question of whether a hub-and-spoke configuration might encourage a new U.S. protectionism that would seek to protect U.S. firms against competition, not just in the domestic U.S. market as always, but *also in the markets of spoke countries* where U.S. exporters would be protected by preferential treatment.

The problem with such domestic-export protectionism is that it might be able to disguise itself as free trade much more easily and persuasively, precisely because it would be the defense of a set of U.S. bilateral free trade agreements. But it would still be a dangerous form of protectionism, insofar as it could be used to resist the two more appropriate objectives of U.S. trade policy — namely, an expanding FTA or multilateral free trade.

It is in the interests of all countries concerned — including the United States, the apparent beneficiary of a hub-and-spoke — for future trade liberalization in the hemisphere to follow an FTA, rather than a hub-and-spoke configuration. Thus, if, under the pressure of time, all that can be negotiated is a U.S.-Mexico bilateral, it is essential that all countries concerned be committed to a specified timetable for transforming the resulting North American hub-and-spoke system into a tripartite FTA. At that point, future applicants for a bilateral with the United States can instead be offered entry into the FTA.

Discussion

Professor Anne O. Krueger of Duke University and Mr. Jeffrey Schott of the Institute for International Economics in Washington were asked to lead off the discussion, after which the proceedings were opened to roundtable comments by all participants.

Professor Anne Krueger
(Duke University):

Ron Wonnacott makes an important and stimulating contribution. I am largely sympathetic to his viewpoint, but I will focus on those aspects that I think need further elaboration.

Should the hub-and-spoke system expand further after Mexico has become a spoke, there could still be substantial benefits to Mexico to offset the negative effects of the erosion of its preference in the U.S. market. This would be due to higher Mexican growth from gaining improved access to the U.S. market. This could lead to much more trade creation than trade diversion, and thus to even further growth.

On the issue of the effects of adding a third spoke to the hub-and-spoke system (which diminishes the benefits for the first and second spokes), the spokes can partially offset their disadvantage by unilaterally removing their trade barriers in general. In the case of Canada, this would eliminate the cost disadvantage Canadian producers would have *vis-à-vis* U.S. producers. However, Canadian producers would still face discrimination in the Mexican market in competition with U.S. producers.

A serious disadvantage of the hub-and-spoke system is its potential for legal complications, especially for the hub country. This could reduce the gain for the United States from this system, as a host of regulations that are different from country to country would develop. Suppose that to deal with disputes arising under the agreement, a U.S.-Mexico dispute-settlement panel were created that parallels the one created by the Canada-U.S. FTA. Suppose that this panel then produced judgments different from those of the Canada-U.S. panel. This could result in a negative effect for all signatories given the potential for cross-rulings that may well open up many opportunities for private gains that are not social gains. No doubt, resources would be devoted to exploiting such opportunities.

My main worry about Professor Wonnacott's paper is that it treats the Canada-U.S. free trade agreement as if it were a free trade agreement. It is really an agreement to limit trade barriers in certain areas and simultaneously to lessen the threat of U.S. protectionist action against Canada. In return for some trade concessions, Canada was granted immunity from some of the legal harassment that U.S. producers could otherwise have attempted under U.S. trade law.

Many other areas are either taken out or set aside to be dealt with by a special protocol. These include agriculture, construction, the Multi-Fibre Arrangement (MFA), and many services. If the Canada-U.S. FTA were in fact a free trade agreement, I would agree with everything in Professor Wonnacott's paper. However, many issues arise because it is only a partial free trade agreement.

As with the Canada-U.S. FTA, a U.S. agreement with Mexico will contain special protocols to deal with issues beyond tariffs. This will give rise to temptations for a special fix for many sectors. In its bargaining, Mexico will have to identify the areas that are of greatest interest to itself. Presumably, these would include such things as the MFA, fruits and vegetables, labor-intensive services such as construction and road building, and immigration. None of these issues was central to the Canada-U.S. FTA.

From the U.S. viewpoint, it is unlikely that maritime transport would be in the agreement because of strong political pressures. If Mexico is going to overcome such barriers, it must identify areas where the United States will benefit from a free trade agreement and then threaten not to offer concessions in those areas. In this way, it could get U.S. concessions in the areas of particular interest to

Mexico. Including Canada in the negotiations would make them even more difficult for the Mexicans than they already are, because the issues of central importance to Mexico need not be those of central concern to the Canada-U.S. relationship.

While we should not want to reopen the Canada-U.S. agreement, there are parts of it that are very important to Mexico that need to be brought in. I do not know how this should be handled, but the way the Canada-U.S. negotiations were conducted let the agreement to some extent become a hostage of special-interest groups in the United States. That should be avoided in the case of Mexico.

Yet another set of vested interests on both sides will come into play in talks with Mexico. Mexico must correctly identify those in the United States who will support it, and threaten not to include them unless the sectors in which Mexicans benefit most are included. The hub-and-spoke system seems to offer the greatest opportunity for such an approach.

Mr. Jeffrey Schott
(Institute for International Economics):

A problem can arise in the sequencing of free trade agreements in a hub-and-spoke system, if one country thinks it has received a worse deal than the new deal that has just been negotiated. Israel complained about some elements of the Canada-U.S. agreement, including services and the Canada-U.S. dispute-settlement arrangements, and demanded similar treatment under its FTA with the United States. However, this did not generate any strong political opposition in the United States to the agreement with Canada.

Professor Wonnacott is correct to emphasize the negative implications for the multilateral process of the hub-and-spoke system. A further problem is one of sequencing: potential spoke countries would queue up to join to maintain their market access to the United States and avoid getting edged out by competing countries, which might get a better deal first. This is a defensive strategy less aimed at trade liberalization than at simply maintaining existing market access.

The sequencing problem and the concern that future U.S. bilateral partners will get a better deal does raise the key question of coverage, as Professor Krueger has pointed out. These are freer trade deals, not free trade deals. They result in tariff-free zones, but they differ markedly in reforms of nontariff barriers. They lead to different trading rules and exemptions, or to special treatment of the kind that Canada got under safeguards and to some extent under the countervail provision. They can also lead to different administrative provisions — not only on the dispute-settlement procedures, but also on the administration of the agreement.

In the past, such problems have not caused major concern for the countries' obligations under the GATT; the requirements for establishing a free trade area under Article XXIV have essentially been ignored. There have been no cases where a preferential bilateral or regional trading agreement, as these are, has been rejected as inconsistent with the GATT, yet almost none has been accepted as being fully consistent with it. Of the more than 50 preferential trading arrangements for which the GATT has received notification under Article XXIV, most lie in some grey zone where GATT member countries reserve their rights to retaliate if they see fit, although such action has seldom been taken. An important issue in the future will be whether the 1985 proposal by the GATT "Wisemen" to strengthen Article XXIV will be acted upon or lost in the conflict over other issues such as agriculture.

Professor Wonnacott assumes that the United States is the hub country, but couldn't Mexico perhaps also become a hub by negotiating a free trade agreement with, say, Chile? This is just speculation, since it is not clear that the current Mexico-Chile talks will ever get that far; in any case, the markets are simply not there. The market of real importance is that in North America.

The interest of the United States in pursuing these bilaterals is more political than eco-

nomic. What economic gain does the United States have in pursuing a hub-and-spoke policy outside North America? Even with the U.S.-Mexico agreement, the foreign policy and political objectives far outweigh economic objectives. This holds even more in the case of countries in South America.

Once again, this raises further coverage problems. Is the United States, to attain political objectives, going to remove its textile quotas on Chile, Brazil, Argentina, or even Mexico? Are there enough economic gains from any of these single bilaterals to justify major changes in existing U.S. policy? This reinforces Professor Krueger's claim that there is a real risk that a hub-and-spoke approach will lead toward discriminatory sectoral arrangements, as opposed to free trade. With limited coverage, such agreements would require GATT waivers under Article XXV (as the United States sought for the auto pact).

From a Canadian perspective, can Canada take advantage of new negotiations to try to resolve issues left over from the Canada-U.S. FTA? Such issues might include subsidies, countervail, antidumping, intellectual-property rights, and transport and other services. Is Canada better off trying to get results in those areas if Mexico is included in a trilateral agreement? Or would Canada be worse off because it will be pressured to reopen issues, such as investment in the energy sector? It seems to me that having Mexico involved will not be very useful in dealing with Canada's remaining problems.

The United States has made nothing public about the agenda of the talks with Mexico or of a possible trilateral negotiation. Discussions on the agenda are just beginning and are rather open-ended at this point. I would assume, in light of the Persian Gulf crisis, that the energy investment issue would come forward for both economic and security reasons.

Professor Ronald Wonnacott:

Several interesting points have been raised. For example, what happens if other hubs are created? To what degree should the Canada-U.S. agreement be reopened in negotiations with Mexico? True, since that agreement is imperfect, a case can be made for reopening it in order to improve it. But that is dangerous, because once it is reopened it may instead be damaged by protectionist interests. This would also establish a bad precedent in future negotiations with potential new partners. Reopening an existing FTA whenever a new partner is added would inappropriately increase negotiating costs and political fallout in existing member countries.

It is worth emphasizing that one of the advantages of an FTA is that it prevents new U.S. partners from getting better treatment than existing partners. In its FTA negotiations with the United States, Canada attempted to ensure that the United States would not give such special treatment to any new partners, but this attempt failed.

Dr. Robert Z. Lawrence (The Brookings Institution):

From the U.S. point of view, the hub-and-spoke system will be attractive should countries approach the United States and offer to open their markets completely and without exception. Compare that with negotiating plurilaterally with a large group of potential free trade partners, where the end result is the lowest common denominator and agreements full of exceptions. This is an argument for the hub-and-spoke model that will be used.

Professor Sidney Weintraub (University of Texas, Austin):

In looking at where the system will evolve over the next decade, I think that whichever route to freer trade is taken, the end result will be quite similar. The spokes can have their own bilateral agreements, for instance.

Professor Krueger is quite right about the dangers of the increasing administrative complexity of the hub-and-spoke system. It was to avoid this that the United States shifted from conditional to unconditional most-favored-nation (MFN) treatment in the 1920s. That is

what could happen with a hub-and-spoke system if it became too large.

On the issue of whether or not "export protectionism" would grow, one must ask what the multinational corporations want to use the spoke countries for. Do they want them as markets or as production bases? If they want them as export markets, the multinationals would then favor export protectionism. If, however, they want them as production bases — as is increasingly the case with Mexico — then the multinationals gain no advantage from maintaining export protectionism.

Professor Ronald Wonnacott:

The answer to this may depend on whether or not a hub-and-spoke system is already well established. If it has not been established, the multinationals might well prefer an expanding free trade area to rationalize their production. However, if a hub-and-spoke has already become established and U.S. multinationals have distribution systems set up to take advantage of the preferences it provides, they may well want it to continue.

Effects of Freer Trade on Factor Prices

Professor Robert Dunn
(George Washington University):

Discussions of free trade arrangements make the assumption that certificates of origin or content requirements are fully enforced. If this is not the case in practice, there is a possibility that a hub-and-spoke arrangement between the United States, Canada, and Mexico could end up looking like a free trade area. Falsified certificates of origin could be used to allow Mexican goods to pass duty free through the United States and into Canada. Some might be modified en route in U.S. "screwdriver factories", but some might not.

There are also Heckscher-Ohlin effects that could produce a similar outcome. Mexican exports to the United States will be heavily labor intensive. A U.S.-Mexico free trade area would put downward pressure on U.S. wage rates for unskilled and semi-skilled labor, with corresponding upward pressures on returns to other factors of production. This will tend to make U.S. exporters of labor-intensive goods such as garments and shoes more competitive in the Canadian market.

These forces acting on U.S. wages, the use of "screwdriver factories", and the potential for cheating on rules of origin would all produce downward pressure on Canadian wages. The result could be similar to a free trade area among the three countries.

Professor Weintraub:

I disagree with Professor Dunn's analysis of what would happen to wage rates. The pressures for downward movements in wages would occur among unskilled workers, but there is little room for this given a minimum wage. At the same time, there are increased incentives to export goods at the high end of the market, and there are pressures for wages to rise there. This should help to raise U.S. incomes in the long run. In fact, this is a purpose of such agreements: a country can force itself to become more efficient.

For Mexicans, their labor productivity will increase and their wages and incomes should rise over the long run.

Mr. Gordon Ritchie
(Strategico Inc.):

Professor Dunn raises the question of flowthrough based on unenforced or falsified certificates of origin. Some of that is undoubtedly going on already. There was great Canadian concern at the time of the FTA with the United States that Maquiladora production would flow into Canada. In fact, under the FTA as implemented, it is virtually impossible for these products legally to move into Canada duty free because U.S. components in these goods are viewed as Mexican once they are brought back across the Mexican-U.S. border.

While there might be some illegal movement, it poses no threat to Canadian producers. If there were any significant flow of a product where Canadian producing interests

exist, they would notice it and it would be blocked at once. Fairly significant flows are possible only if there are no domestic producer interests.

Gains for the United States in a Hub-and-Spoke System?

Dr. Richard Belous (National Planning Association):

Professor Wonnacott discusses the economic benefits the United States can get from manipulating a hub-and-spoke system, but argues that the United States should not engage in this. This argument can be supported by making a distinction between the short run and the long run.

In the short run, the United States gains, but then in the long run, as Professor Weintraub noted, the spoke countries can start making their own agreements, and much of the short-run U.S. gains would evaporate. Most of the advantages of the hub-and-spoke system are just short-run advantages.

I prefer an argument like this, rather than one which claims that the United States should not pursue its own advantage through the hub-and-spoke system for reasons of high moral principles.

Professor Ronald Wonnacott:

Compared with a free trade area, a hub-and-spoke system depresses the potential income of its members, but provides preferential benefits to the United States. This is true in the short run *and* in the long run unless, as Dr. Belous points out, the spoke countries in the long run make their own bilateral agreements, which would transform the system into a free trade area of a sort.

But there is no guarantee that they would do that. If they do not, then this limited analysis of preferences indicates that the hub-and-spoke remains better for the United States than a free trade agreement. However, once the analysis is broadened to consider the damage from export protectionism and the rent-seeking abuses pointed out by Professor Krueger — along with possible damage to U.S. foreign policy objectives — a hub-and-spoke system, in my view, would be likely to damage, rather than to benefit, the United States.

Will Spoke Countries Try to Transform a Hub-and-Spoke into an FTA?

Professor Paul Wonnacott (University of Maryland):

Is there any reason why the spoke countries would not want to "fill in the rim" of the wheel once their bilateral agreements with the hub have been made? If they do, then in the long run the hub-and-spoke system is basically unstable. The exploitative gain for the hub country would disappear.

Professor Ronald Wonnacott:

It is quite true that it would be in the interests of the spoke countries to fill in the rim, but political difficulties could prevent them from doing so — just as political constraints have prevented countries in the past from pursuing their economic interests by, say, unilaterally removing their own protection.

Trade between Mexico and Canada is so small — at least at the moment — that the question of whether they will trade freely (in an expanding FTA) or with continued barriers (in a hub-and-spoke regime) seems, on the face of it, to be relatively unimportant. However, it seems to me that the choice of regime will be important, not only in influencing a rapidly expanding Canada-Mexico trade, but also where it matters most — in the U.S. market. In a hub-and-spoke system, producers in both Canada and Mexico will be less able to compete with U.S. firms not only in the U.S. market, but in other markets as well because U.S. firms alone will have the advantage of being able to acquire duty-free inputs from all three North American countries.

Professor Weintraub:

Canadian-Mexican trade is small, but a focus on this alone is too narrow. It is also important to consider what kind of investment will take place.

Negotiating with the United States

Mr. Ritchie:

Professor Krueger's comments about the protectionist aspects of the Canada-U.S. FTA open up interesting territory, although I would argue that this agreement is as much or more of a free trade agreement than any others that have ever appeared before the GATT.

Concerning the derogations in that agreement from free trade ideals, it is important for everyone to realize how hard it is to negotiate with the United States. This is, in part, due to the huge gap between theory and practice in the United States.

To be very clear about it, virtually all the derogations that make this agreement not a full free trade agreement, were made at U.S. insistence. This includes the derogations concerning the MFA and transportation services. Trade policy in the United States is very much caught up in the congressional system, subject as it is to all the pressures of special interests. Even worse is the "fast-track" process. I have watched this process at work and find it both interesting and dangerous.

First, it sets a timetable that lends itself to the "Yankee trader" attitude that you cannot conclude a deal until the deadline (indeed after the deadline), because if a deal is reached earlier, it is because you have not squeezed enough and ended up leaving money on the table. Mexican negotiators have not experienced this, but they soon will.

Second, the fast-track process lends itself to some very damaging side deals between the administration and Congress. In the Canadian case, while approval was given for the process by Congress, the price was a side deal whereby the administration essentially promised to restrict the Canadian forest products industry in any way it could. It did so with trumped-up cases against cedar shakes and shingles and softwood lumber.

The fast-track system also leaves U.S. negotiators driven not by any model of trade liberalization, but by the latest congressional representation they have had. I have no doubt that Congress, or the special-interest groups it represents, will have an agenda for the Mexicans that will include oil and gas, services, restrictions on fruits and vegetables, restrictions on textiles, and a number of other special features.

If U.S.-Mexico negotiations were trilateralized, the unfinished U.S. agenda with Canada would emerge. For instance, protection of "intellectual property", which sounds like a worthy objective, really means — when it comes to the negotiating crunch — that the Americans want to get rid of the generic drug-licensing scheme in Canada. Cultural industries will still be on the table; *Time-Life*, to my knowledge, has not lost its clout.

Most crucial is the issue of subsidies, which would be opened up for discussion. However, it is worth underlining that neither the Canadians nor the Americans got quite what they wanted out of the FTA on that issue.

I wish to inject a note, not of cynicism, but of realism in terms of actual negotiating practice. The U.S. team is driven by a Congress that is completely governed on these matters by special-interest groups. U.S. negotiators will not be looking at the broad principles of free trade and trade liberalization; they will be looking at very specific fixes for particular sectors, which will be different from the ones they were looking at with Canada. The issue then is: Will a trilateral negotiation reopen these unfinished agenda items with Canada and complicate the negotiations with Mexico?

Dr. Arlene Wilson
(Congressional Research Service):

I agree with your view that it is getting progressively harder to achieve trade liberalization. The problem of special interests has been increasing in the past ten years, but special-

interest groups do not completely govern trade policy in Congress.

The Canada-U.S. agreement came to Capitol Hill very abruptly — and necessarily so, because all the negotiations occurred at the end — and few there fully understood it. It was a very complex technical document, and this generated some misunderstandings.

As well, it was presented to Congress as an agreement to benefit U.S. trade in the near future, but I think it was not that kind of an agreement. The trade policy objectives in the agreement are more long run. In the short run, there has not been a large growth in trade, nor should that have been expected.

Another part of the problem in the United States was that this country did not study the agreement as thoroughly as Canada did. For the United States, it was more a foreign policy decision. Given this, it should have been presented to Congress in terms of its foreign policy benefits and not its economic benefits.

With Mexico, the issues are being examined quite early in the negotiating process. Congress recently asked the International Trade Commission for a study. However, the problems are different from those with Canada. In terms of the pressures facing Congress, subsidies do not seem to be as important an issue as they were for the Canadian negotiations. (However, these pressures did not arise early in the Canadian negotiations either.)

Professor Peter Morici
(University of Maine, Orono):

The Canada-U.S. agreement substantially liberalizes in many areas; what it really does is to establish a series of processes. If the United States pursues more bilateral agreements, the real danger is that similar processes will be set up that will constrain the other spokes in their ability to create the rim of the wheel.

The United States, as we have found in the GATT, will be able to infringe on the rules and can do so with each of its partners. But its partners will not be able to violate the rules so easily, because the United States will be vigilant in enforcing its rights and privileges.

The problems of negative congressional pressures on trade liberalization can be overstated. Each member of Congress seems to consider the interest of his or her district, and broader goals. If they did not, presidents could not continue to get fast-track authorization and have the resulting deals passed.

An advantage of dealing with Mexico alone is that it may be possible to do things with Mexico — on textiles, for example — that cannot be done with all the developing countries at the same time. Mexico may be able to get benefits because of its political circumstances that other developing countries cannot get.

Mr. Ritchie:

Canada came to the negotiations with a view driven much more closely by the concept of trade liberalization for the purpose of achieving economic goals. We were in fact starting from a premise of eliminating all barriers.

The problem is not a matter of pushing Canada to do more — quite the contrary. Canada was prepared, for example, to move on transportation services. Indeed, it was in the preliminary agreement, but the United States reneged at the second stage.

Because of the U.S. congressionally dominated negotiating process, there will be very significant derogations from any pure free trade model in a bilateral negotiation with Mexico. Matching those derogations with those the United States insisted on with Canada would be extremely difficult and complex.

The problem is there is no easily transportable pure free trade model, but instead one with a very substantial number of derogations. Further, there are interests on both sides. In the negotiations, the Mexicans are going to have sectors they will want to protect. Still, I suspect that, as in the case with Canada, Mexico's initial position will be one in which it is prepared to undertake much greater liberalization than the United States. It will be the United States that will insist on derogations which will then open the door to pressures for Mexican special interests.

Professor Krueger:

Where U.S. protectionism is the strongest, it is not at all clear that making the negotiations trilateral would be helpful. One must decide which route best neutralizes U.S. protectionist pressures in the sectors of most interest in this agreement. Can this be done in a framework that could later be transformed into a "core", under which various bilateral agreements could come together?

Rules of Origin

Professor Ronald Wonnacott:

A number of participants have noted that if Mexico and the United States were to get their bilateral agreement, the resulting hub-and-spoke system could be transformed into a trilateral free trade area by a Canada-Mexico bilateral. Could not almost the same result be achieved by instead changing the rules of origin in the two bilaterals while leaving untouched the barriers to trade between Mexico and Canada?

Specifically, the existing Canada-U.S. bilateral allows goods to enter Canada duty free from the United States if these goods have 50 percent U.S. and/or Canadian content. If, as Gordon Ritchie has suggested in an earlier conversation, this were to be phased into a 50 percent U.S.-, Canadian-, *and/or Mexican*-content provision, then Mexican goods could enter Canada as freely as U.S. goods, provided they passed through the United States. Similarly, Mexico could change the rules of origin in its bilateral with the United States by phasing in a 50 percent U.S.-, Mexican-, *and/or Canadian*-content requirement. The result would be three-way free trade *provided Mexican-Canadian trade passed through the United States.* (Ocean shipments between Canada and Mexico would not be duty free because there would be no Canada-Mexico bilateral to remove barriers to this trade.)

Because the United States is geographically the natural conduit for most Canada-Mexico trade in any case — and this probably is one reason why direct Canada-Mexico trade figures are so low — the result would be two bilaterals that would closely simulate a trilateral FTA. The difference would be a loss in efficiency — and an artificial attraction for investment in the United States — because all duty-free trade between Mexico and Canada would be forced through the United States. But because the United States is the least-cost route for a lot of Mexico-Canada trade, the loss of efficiency would not be substantial. Moreover, by delaying the phase-in of these new "trilateral" content requirements, interim protection against Mexican imports could be provided for Canadian industry, thus moderating a major political concern in Canada.

Once this *de facto* trilateral free trade simulation is fully operating, the final, relatively minor, move to full trilateral free trade could be made by removing barriers to direct Canada-Mexico trade. This would not only remove any remaining inefficiency, but also provide a satisfactory structure for a possible future expansion of the free trade domain to include other countries, such as Brazil. (The reason that modifying rules of origin would not provide for satisfactory free trade simulation for other countries in the future is that the United States is not a natural conduit for Brazil-Canada trade or Brazil-Mexico trade. So any attempt to use this approach would, by artificially and expensively directing such trade through the United States, lead to substantial distortions in trade and investment.)

Mr. Ritchie:

The rules of origin are the most central item in a free trade agreement. They determine which goods qualify and which do not. The present situation in the Canada-U.S. FTA is that rules of origin either follow a formula related to changes in tariff heading or a 50 percent direct cost of processing incurred in either Canada and/or the United States.

Changing the rules of origin to accommodate Mexican production in order to move toward some form of trilateral arrangement would still leave some serious problems. While the real Canadian problem will indeed be the

greater competition Canada would face in the U.S. market, the political problem would instead be seen as increased Mexican competitiveness in the Canadian market.

Canadian protectionists have focused their attention on the perceived threat to Canadian jobs, wages, and living standards from exploited Mexican labor. This will be the subject of intensive debate.

This political problem could be dealt with using some North American rule of origin to include Canadian plus Mexican plus U.S. contributions to the direct cost of processing, at some significantly higher number than 50 percent — 70 or 80 percent, perhaps. For example, this rule could remain in effect for five years, after which it could be reduced in stages to 50 percent over the next five years or so. This would leave five years with a much higher combined rule of origin, and then five years during which the limit is phased down. One would not then differentiate between sources of production. That is administratively quite feasible. It does ensure that the benefits are achieved at the end of the process from attaining consistent rules of origin.

Professor Ronald Wonnacott:

As I understand it, you are suggesting that one way of phasing in an expanded and more liberal rule of origin could be this: Initially, Canada would allow imports in duty free if they satisfy the current 50 percent U.S.- and/or Canadian-content provision in the Canada-U.S. FTA, *or* if they satisfy a new, say, 80 percent U.S.-, Canadian-, and/or Mexican-content provision. This 80 percent would then eventually be phased down to 50 percent. At that point, Canada would give Mexican goods the same duty-free status as U.S. goods, provided they were shipped through the United States.

Mr. Ritchie:

Yes, that's right. The core of an agreement can be attained on a trilateral basis or using coordinated bilaterals. This core is the elimination of tariffs with a North American rule of origin. The question then becomes how one gets to this core.

Mexico and Canada should argue for their tariffs to be phased out over a longer period of time, while phasing in a North American rule of origin. All the other issues that are the heart and substance of the Canada-U.S. FTA would be dealt with on a bilateral basis.

Professor Morici:

Would Canada want substantially different rules of origin than the United States? Mexico provides less than 2 percent of Canadian imports, but it is still Canada's largest Latin America trading partner.

Mr. Ritchie:

Trade with Mexico is relatively insignificant. The economics and the politics collide on this. Concerning the rules of origin, Canada should be keen to have very liberal rules of origin so that, combined with our restrictions on immigration, we can encourage an exodus from Canada and into Mexico of those industries that depend on low labor costs. That is what Canada *should* be doing.

However, Canada will *actually* be highly protectionist in low-wage labor-intensive industries even though we will then ironically find ourselves having to attract immigrants to fill the jobs in textiles and clothing. (Almost all the workers in those industries are recent immigrants to Canada.) An agreement with Mexico would excite very strong and very dangerous political opposition, not only from organized labor, but from some provincial governments and at least one and probably all opposition parties in the House of Commons.

The rules of origin could be very simple. Instead of the present 50 percent Canadian-plus-U.S.-content requirement, a more liberal regime could actually say that 50 percent Canadian plus U.S. *plus Mexican* content would be required. Almost all of the goods that will benefit from that kind of rule of origin would be U.S. components processed in Mexico with Mexican labor. This would be beneficial from the point of view of consumers and would

hasten the departure of low-wage industries from Canada.

But there is still a not-insignificant element of the Canadian labor force engaged in the assembly of U.S. components for sale in Canada and the United States. As a result, Canada will almost certainly require the more restrictive present rule of origin and only phase in a more liberal regime later.

Special Problems in a Hub-and-Spoke System

Professor Morici:

It may be that a succession of bilateral agreements leads to certain problems that a more inclusive arrangement could avoid. Suppose, for example, that the United States liberalizes textile trade with Mexico, allowing the Mexican market share to grow. Then suppose that Brazil wants a similar arrangement.

Assuming that Mexican income levels had risen, the United States might well want some mechanism to force Mexico to bear some of the adjustment costs from this. But if the United States negotiates a series of bilaterals, it is the U.S. economy that accepts all the adjustments inherent in bringing in new partners. Whereas if we are involved in a broader agreement with other countries, then they would share adjustment costs too.

Dr. Laurence:

In considering the problem from the Mexican perspective, a quantitative sense of these various considerations is important. Professor Wonnacott's paper raises a couple of points.

First, suppose Mexico is included in a North American FTA. If the United States then goes on to expand that FTA to include more countries, Mexico would lose a lot of benefits from its preferential access, but at least those benefits would have been gotten for some period of time. The "first mover" advantage would eventually be whittled away, but even then, Mexico would be no worse off than if it had begun in the same expanded free trade area.

Second, if the United States instead signs new hub-and-spoke bilateral agreements, discrimination would result against Mexican products, as the United States would then have privileged access to the market of each new spoke. How important is that for Mexico? To what degree do Mexican products really compete with U.S. products in third markets? I would guess that there is not much competition there. It is important to have a sense of the magnitude of these numbers.

Professor Ronald Wonnacott:

In addressing the question of the magnitudes involved, my own feeling is that the effect of a hub-and-spoke system is cumulatively important in the Americas. Whether the United States has a bilateral agreement with Peru is not going to be very damaging to Mexico, although it may be in certain industries. But if the United States signs bilateral agreements with many countries in the Americas, then the cumulative damage to Mexico could be serious. And, of course, this damage would become even greater if the United States were to extend its bilateral agreements into East Asia or Europe.

Mr. Schott:

There is one more point. Spoke countries face more competition if the United States gains more spokes, but what happens to them if the United States has a free trade agreement with other hubs, such as Japan or Europe? Then the competition that Mexico faces in the U.S. market would be much more severe.

The "Hub-and-Spoke" Analogy

Mr. Ritchie:

The symbolism of the debate could be important. The "hub-and-spoke" analogy may be a powerful one, but I have some trouble with it. Reality is far more complex than a hub-and-spoke model. The wheel, for instance, has rims; whether they are pure "free trade" rims or not is another question.

Professor Ronald Wonnacott:

I agree that the real world is far more complex; any final agreement is almost surely to lie between the hub-and-spoke and the free trade area extremes. At the same time, it is important to recognize the broad direction in which the trading system may be developing over the next decade — whether in the direction of an expanding free trade area or in the direction of a hub-and-spoke model. While a free trade area is preferable collectively and for almost all — if not all — countries concerned, the consensus here seems to be that something less than that will emerge.

Professor Krueger:

The hub-and-spoke concept originated a couple of years ago at the same time that the South Koreans were using a "star" concept, where other countries were points and the United States was the center. As a descriptive phrase, the "hub-and-spoke" for some reason won the day. It is a way of organizing thinking and seems useful as a way of getting across the difference between multilateral and bilateral arrangements. Is a better analogy available? The hub-and-spoke description is not completely accurate, but it seems better than any alternative I have seen.

Mr. Ritchie:

The problem with the hub-and-spoke analogy is not just that it misses the idea that there is a rim of some sort on the wheel; in addition, and possibly more important, there is a presupposition that, after Mexico, more countries in Central and South America will be added. It is in this extension to other countries that complicated issues arise.

I would be very surprised if the United States' negotiating energies were not spent after its deal with Mexico. It seems to me that the chances of negotiations being extended further in the Americas are negligible. The United States' preoccupation must be with Europe, Japan, and the newly industrialized countries. The exception to this would be a real failure of the Uruguay Round followed by an exacerbation of relations between the three major trading blocs and the construction of a "Fortress America".

Expansion of a North American Free Trade Area?

Mr. Schott:

The United States is looking beyond an agreement with Mexico, and that suggests that a more integrated free trade agreement in North America is desirable. What is driving the "Enterprise for the Americas" initiative from the U.S. perspective has less to do with trade policy goals than with foreign and economic policy goals, including investment and debt.

Dr. Nora Lustig (The Brookings Institution):

That may well be the U.S. position, but I do not think that is the position of many Latin American countries. They view trade as a major component of the "Enterprise for the Americas" program and they will press to make that a reality. From the Latin American perspective, Mexico is seen as a country that will likely get most of the advantages (from a foreign policy perspective) compared with the other Latin American countries, for a variety of reasons.

If these other countries enter into similar agreements with the United States in the future, they can probably push for a similar deal given that Mexico would have already gotten the maximum that was possible. This provides them with an ideal to strive for.

They are also trying to position themselves advantageously, since none of them has Mexico's advantage in being a border country. Perhaps they can offer other things if they join into groups themselves. We now see this tendency for such groups to be formed, especially in the Southern Cone. Argentina, Brazil, and Uruguay, for instance, will have more bargaining power in the future because they will have more to offer.

Thus, there are incentives for countries beyond Mexico to work on bilateral agree-

ments or to form clusters of countries, while not necessarily joining Mexico at this point. If Mexico goes first, the result may be more for everyone, including Mexico.

Professor Dunn:

I might add that the Caribbean Basin Initiative (CBI) countries are another potential spoke that has not yet been discussed here. The CBI is not a free trade area, but those countries do have preferential access to the U.S. market.

The last part of the day's program centered on the actual negotiations with Mexico. Mr. José Luis Bernal was asked to offer a Mexican viewpoint, Professor Morici a U.S. viewpoint, and Mr. Ritchie a Canadian viewpoint. Professor Weintraub was asked to comment on the possible expansion of a trilateral agreement to include other countries. This was then followed by further roundtable discussion.

A Mexican Viewpoint

Mr. José Luis Bernal
(Embassy of Mexico, Washington, D.C.)

[Note: The views expressed by Mr. Bernal are his own and do not necessarily represent the official position of the Mexican government.]

Professor Wonnacott's paper is useful in helping Mexican policymakers assess the long-run benefits and costs for Mexico in choosing a bilateral free trade agreement with the United States or exploring the possibilities of trilateral negotiations that include Canada. Of course, the ideal or best-case scenario would be to have multilateral free trade negotiations work. But that has proven difficult in practice over the past four decades. This leads us to a second-best option — that of an expanded free trade area that begins with Mexico, the United States, and perhaps Canada involved in a comprehensive negotiation.

Moreover, political constraints and realities facing the governments of each country may take us to a third-best scenario — one that is more feasible in the short run. My view is that Mexico will begin negotiations with the United States and become a "spoke", but that it will also start a simultaneous negotiation with Canada. This would "fill in the rim", as others here have described it.

The goal would be the convergence within three to five years of the three bilateral agreements (Mexico-U.S., Canada-U.S., and Mexico-Canada). This convergence could take place in a more mature political environment that can eventually deal with trilateral negotiations to make the trade agreement a truly comprehensive North American agreement. This is not to suggest that a decision has already been taken — in fact, it has not — but to set out what I see as the most feasible scenario.

Why did Mexico take the initiative to ask for a free trade agreement with the United States? The answer to this has to do with the economic reforms Mexico has undertaken in the past several years. Mexico has taken the unilateral decision to become one of the countries most open to foreign trade in the world. Although the Mexican domestic market has been depressed and we have suffered a severe lack of financial resources, the data show that Mexican imports have increased at an average rate of over 25 percent per year over the past four years. Also, between 1982 and 1989, Mexican nominal exports increased at a rate of 20 percent per year. These data attest to the increasing competitiveness of the Mexican economy in international markets, one of the main reasons that Mexico seeks a free trade agreement with the United States.

The Mexican government has also enacted a very broad process of deregulation of economic activity, while redefining the role of the state in the economy. In general terms, we have been promoting this overall economic reform under more liberal and open conditions. Nevertheless, we are aware that commercial openness is not the only requirement for a more competitive economy. New domestic and foreign investment is required, and we need to foster the transfer of new technologies.

To achieve these goals, we need a suitable domestic atmosphere. To do that, we must establish clear investment regulations.

Indeed, Mexico has already liberalized regulations on foreign investment. In the first six to seven months of 1990, US$3.5 billion of foreign investment entered Mexico. The prospects for the country are perhaps the best in the past ten years. Almost 70 percent of Mexican foreign trade is conducted with the United States, so for Mexico the U.S. market is crucial. In 1989, U.S.-Mexican trade totalled more than US$52 billion, and it is expected to be US$56–60 billion in 1990.

Mexico is trying to make the United States realize the importance of the Mexican market. Mexico is, and has been for the last few years, the United States' third most important trading partner. US$20 billion of U.S. direct investment is located in Mexico, making up about 63 percent of total foreign investment there. We have developed significant ties in agriculture, oil and other energy products, industrial cooperation, finance, and tourism. We have a very broad social interaction because we are neighboring countries.

What we have been trying to do with the proposal of a free trade agreement is to establish a stable institutional framework within which to conduct our bilateral economic relationship with the United States. We believe that the U.S. government shares the same idea, and that is why we have been trying to find the best way to conduct the free trade negotiation in the coming months.

In our bilateral discussions at the moment, which, I stress, do not preclude the form that the negotiations will eventually take, we are talking about a gradual, but total, elimination of tariffs on bilateral trade. We are proposing the reduction and, if possible, the elimination of nontariff barriers. We are trying to secure the long-run access of Mexican products to the U.S. market, and above all, through the establishment of a new mechanism to settle disputes, we are trying to avoid unilateral U.S. trade policy action.

I know that this sounds very similar to what Canada was pursuing in its bilateral negotiation with the United States. We think the Canadian experience can provide us with a lot of knowledge about how to conduct our own negotiations.

A U.S. Viewpoint

Professor Morici:

Mexican negotiating objectives are clearly similar to what Canadians aspired to in their negotiations. Similarly, the U.S. list for Mexico is remarkably similar to the list it had for Canada. While the specifics are different due to different institutional circumstances, the broad subject areas remain the same. Therefore, it is useful to begin by looking at the issues addressed in the Canada-U.S. FTA and to ask what would happen if this were the agenda for talks with Mexico.

I suspect that many items would be removed from the negotiating table very quickly, more so than in the Canada-U.S. negotiations. For example, Mexican sensitivities about energy are much greater than Canadian sensitivities. Services will be a greater problem, because both the United States and Canada had very similar labor-force structures and wage rates, so the issue of low-wage immigrant labor that the United States has with Mexico did not arise. These will really be trade and factor-flow negotiations.

Textiles will be on Mexico's want list. The removal of U.S. tariffs on textiles will transfer wealth to Mexico, but will not provide market access without the gradual elimination of the MFA quotas. At the same time, free trade with Mexico may help the United States by imposing sorely needed adjustments on the U.S. economy. For example, enough textiles could be imported from Mexico over the next 20 years to force the adjustments that would be undertaken if the U.S. industry faced competition from the rest of the world.

The MFA quotas could be dealt with in a variety of ways. For instance, they could be eliminated, but snap back if the Mexican mar-

ket share grows too rapidly. Eventually, however, they will have to be phased out. How does this fit into the rest of U.S. trade policy?

If the Mexican market share grew to 10 to 12 percent of total U.S. consumption, is the United States willing to accept an overall import penetration ratio of 35 percent instead of 25 percent? I doubt it. Yet unless the Uruguay Round produces a remarkable result, the United States would then have to adopt a more restrictive policy toward its other trading partners. This raises many issues that Americans have yet to think about.

There are important problems in sorting out how dispute settlement would work with a trilateral deal, especially regarding subsidies and antidumping. Unlike Mr. Ritchie, I do think that it is possible to have an arrangement like Chapter 19 (of the Canada-U.S. FTA) with the Mexicans because their subsidy and dumping laws are now similar to ours. The real problem is the lack of experienced Mexican lawyers and judges to sit on panels.

Another set of questions arises when these arrangements are trilateralized. Could we have a panel composed of one-third Americans, one-third Mexicans, and one-third Canadians ruling on whether natural resource pricing was indeed a subsidy? This could create some discomfort in Congress.

New Mexican rules on investment are very significant, because what Mexicans are really doing is trading their economic reforms for market access. However, most of their economic reforms are multilateral in scope: when they liberalize investment, anyone can invest there, not just Americans.

Yet, as the Americans make concessions to the Mexicans, they are granting preferential access to the U.S. market. This is especially important because no other low-wage country — outside the Caribbean — has such access.

But how does this exchange of concessions on the part of the Mexicans factor into the agreement? This will have to affect the rules of origin that emerge from negotiations, otherwise the Japanese would be able to invest in Mexico and export to the United States. Rules of origin can affect this, given Japanese investors' propensity to use Japanese inputs. This should cause the Americans to seek very conservative rules of origin.

From a U.S. perspective, the differences between hub-and-spoke arrangements with Mexico and Canada and a trilateral agreement is not significant in its economic effects. What is important is the precedent set by a hub-and-spoke arrangement. With a series of such arrangements, the United States bears all the adjustment costs. However, I am skeptical that the United States, once it has digested Mexico, will have much of an appetite for other bilateral agreements.

The official policy is to have framework agreements. It is not clear that, when the "Enterprise for the Americas" policy was announced in June, anyone had given much thought to what it would be like to have a large Latin American labor force making steel and textiles, and whether that would end the MFA and the import program in steels, and leave the door wide open to automobiles made with very inexpensive labor.

I very much favor a three-way deal. It will provide many of the benefits that the United States cannot get through the GATT, but many issues remain to be worked through.

A Canadian Viewpoint

Mr. Ritchie:

I will address two questions. First, why should Canada be involved? Second, if Canada is involved, what form should that involvement take?

On the first question, I have no idea why we should be involved, even after listening to all the discussion today. When I list Canadian trade policy priorities, they are:

- the Free Trade Agreement with the United States;
- the GATT;
- the relationship with Japan and Europe.

Another consideration, perhaps of primary importance, is changes in domestic policies to make Canada more competitive. Trade policy itself is not currently a big issue in Canada, however, given the constitutional crisis and preoccupation with the coming recession.

It is worth remembering that even when the government commanded support at over 50 percent according to opinion polls, the FTA with the United States had 40 percent support, with 40 percent opposed. The remaining 20 percent swung either way; in the 1988 election, more than half of them voted for parties that opposed the FTA. Now, the government is at about 15 percent in the polls, the lowest ever recorded in a Western democracy. In such circumstances, it is doubtful whether it can or should take these broader negotiations with Mexico onto its agenda. Such a move would reopen all the battles that were fought over free trade with the United States, calling forth all the old warhorses on both sides of the dispute.

The government, nevertheless, has announced its intention to proceed with the current exploratory discussions. If we do proceed, then at some time in the first decade of the 21st century, there will be a North American free trade agreement involving Mexico.

How will that state be attained? I would favor "putting a rim on the wheel" — that is, doing it through a set of parallel bilateral agreements between all three countries. These agreements would have a set of common elements. This "core" would deal with tariffs and mutually consistent rules of origin. Tariffs would be eliminated; formulas on rules of origin would be worked out.

Each bilateral agreement would deal with ancillary nontariff barrier matters, to which some general GATT rules would apply — such as were incorporated into the Canada-U.S. FTA. For many of these issues, special bilateral deals may be struck. Attempting to trilateralize these does not make much sense. Clearly, these will be managed by bilateral negotiation, whatever the final form of the agreements.

There are further difficult institutional problems to be worked out. It is worth noting that Chapter 19 of the Canada-U.S. agreement does not put panels in a position where they are defining resource-pricing subsidies or anything else. The panels are obliged only to interpret domestic law on the basis of existing jurisprudence. The difficulty in making an arrangement like this with Mexico is that there is no jurisprudence or administrative history to draw on in these matters.

The problem is less one of the nationality of the panelists than of deciding how to carry out a "Chapter 19" process in a Mexico-Canada or Mexico-U.S. dispute. If it was a Mexican measure, such as a countervailing duty, that was at issue, on what basis would one operate?

On the other hand, the institutional provisions in Chapter 18 of the Canada-U.S. agreement would be quite manageable. This provides for dispute mediation by a group of experts, and could be made compatible with a three-way agreement.

I think that an unfortunate error in the Canada-U.S. FTA was to specify *ad hoc* panels to meet U.S. sensitivities. In the future, a standing tribunal with permanent members will be required to handle disputes.

Speed is of the essence in the negotiations. It is very important for Mexico that the negotiations be concluded quickly so that investment decisions can start to prove the value of the agreement and the other economic reforms before the next election. The last one was bad enough, and the next one could be very difficult unless something is done quickly.

As far as Canada is concerned, if Mexico is ever going to do a deal with Canada, it should do it within the next year.

Expanding a Trilateral Agreement

Professor Weintraub:

In the earlier discussion, several people talked about bilateralism or regionalism versus multilateralism. However, this is really not an issue any more. The two coexist. With the European Community (EC) and its arrange-

ments with other countries, and the United States with its Israeli and now Canadian agreements, regionalism and bilateralism coexist alongside the multilateral structure.

Therefore, the real question is how the two can coexist in a way that does as little damage as possible to the multilateral structure. This seems to be the unspoken premise of Professor Wonnacott's paper, where he examines the best way to work out free trade arrangements, rather than to try to deal with the question of regionalism.

It is too early to tell whether or not President Bush's "Enterprise for the Americas" initiative will lead to further free trade arrangements between the United States (or North America) and other countries in Latin America. So far, the response has been remarkably favorable.

Assuming that the Bush administration is serious about the proposal, the best way to go about it is the same way the EC and EFTA (European Free Trade Association) did. That is, the United States ought to avoid negotiating individual bilaterals after Mexico. The United States should tell Brazil or Argentina that should they approach us seeking a similar arrangement, they must first reach a regional agreement in the Southern Cone; the same answer should be given to the Andean countries. Then their regional arrangement can discuss joining the regional arrangement that I assume would exist by then in North America. If there are instead two separate bilaterals in North America, this is more complicated, but the principle does not necessarily change.

I think that there is, in fact, a realistic prospect of regional arrangements in South America. The postwar history of regional integration arrangements in Latin America is one of failure. One of the principle reasons they failed was the unequal benefits that accrued to the participating countries. With high tariffs and other external barriers, the more powerful of the countries got most of the benefits, and the weaker countries suffered most of the costs of trade diversion.

Gimmicks were tried to alter this outcome, such as agreements to specify which country got which part of each industry, but they did not work. However, the attempts this time may start out in a liberalizing rather than an import-protecting mode. Under these conditions, integration stands a good chance of working.

Finally, to smooth this coexistence of regionalism and multilateralism, the countries in the regional arrangements must try to lower their external barriers to minimize the damage to the multilateral system.

Mr. Schott:

Do you feel that the movement toward either bilateral or trilateral free trade agreements leads to a type of convergence — that is, a reduction of barriers or a movement toward a common external tariff because of the effects of different external tariff rates on investment decisions?

Professor Weintraub:

Yes. The difference between a free trade area and a customs union is not as great as is often supposed. Once enough time has passed, pressures emerge to lead to similar external tariffs because of investment decisions.

Dispute Settlement: Subsidies and Dumping

Professor Morici:

The heart of a free trade area is dispute settlement. It provides for continued enforcement of GATT norms. Many of the decisions taken under Chapter 19 of the Canada-U.S. FTA were very technical. Certainly jurisprudence and precedent are part of it, but the essence of Chapter 19 requires that the law be applied. So, if Mexican law is clear and explicit, there is a role for a kind of Chapter 19 mechanism.

Mr. Ritchie:

But how does one know if the law is correctly applied? In the Chapter 19 cases, the U.S.

Department of Commerce was taking presumptive evidence that was contrary to their earlier established practice. What one could do for Mexico is to apply the standard Canadian or U.S. practices and impose them on the Mexican system, but I do not think the Mexicans would accept it.

There is another real danger from the Canadian and Mexican points of view. In the negotiations with Canada, the United States tried to get agreement on a subsidies code, but in fact it was basically a code to be applied to Canada, not to the United States.

It was a code that would prohibit financial assistance to Canadian firms selling to the U.S. market. The United States tried and failed to have this accepted. It has tried in the Uruguay Round to impose many of these same things. This is likely to be a major item in its agenda with Mexico — and Canada, too, if it were involved. It would be designed to put very substantial limits on the kind of assistance that Mexican federal or state governments could provide industry in Mexico. As the Mexican negotiators are aware, those rules will be entirely one-sided.

Professor Morici:

This was the real Canadian motivation for having Chapter 19 in the Canada-U.S. agreement. It was not possible to negotiate a subsidies code with the United States. Now Mexico will go for a similar arrangement, and this will take the place of a subsidies code. Chapter 19, in effect, becomes the long-run solution.

Mr. Schott:

You can make the same statement with or without a Mexican agreement to a Chapter 19. There is very little basis for Canada and Mexico to get the changes they want in U.S. trade laws on subsidy. They have a choice between Chapter 19, with whatever benefits it applies to the evolution of U.S. countervail policy, or they have nothing.

Mr. Ritchie:

Unless the Americans get the Mexicans to agree to a subsidies code tailored to U.S. wishes.

Mr. Schott:

Yes. That would be a substantial restraint on Mexican domestic economic policy.

Professor Weintraub:

Most contingent protection is now coming from dumping, not subsidies. What happens to dumping under a free trade agreement? Once you reach free trade, how can you have dumping?

Professor Morici:

This was the argument made by Canada in its negotiations. The idea was that the two countries formed one market, so that dumping was not possible, by definition, because there would only be a single market. But with a single market, there must be common practice with regard to predatory pricing and competition policy. While there are differences in law and practice between the United States and Canada here, the real stumbling block is congressional sensibilities about sovereignty. Such sensibilities would be even greater with regard to Mexico. The best that U.S. trading partners can hope for is to force the United States to apply its laws as they are written, and not as its partners might feel they should be.

Mr. Ritchie:

The U.S. side was unwilling or unable to agree to the elimination of dumping rules in the Canada-U.S. FTA. However, this is still a possibility for the future.

Mr. Schott:

A broader international move to deal with competition policy would ease the transition in a free trade area. The pressure for this arises not so much within North America, but from

U.S. trading relationships with the major markets in Japan and Europe.

Energy Policy

Professor Morici:

In the early 1980s, Canada had differential prices for energy exports and domestic use, and limited supplies to the United States. A screening regime kept out new foreign investment, while an attempt was made to buy out what was already there. Subsequently, the dual-pricing system was scrapped and export restrictions were weakened.

The free trade agreement does not state that Americans can buy Canadian oil wells — petroleum is explicitly omitted from the investment requirements. Nor does it require that Canadians sell Americans their oil. It requires that if there is a supply disruption, the shortage will be allocated among existing customers. It does prohibit export taxes and the dual pricing of exports. Canada is required to offer oil to the Americans at the same prices that it is offered in Canada.

Thus, Canadians maintained sovereignty over their energy resources in the trade agreement. Would Mexico go so far as to commit itself to selling oil to Americans at the same prices it sells to Mexicans, but only for whatever oil they chose to sell? This rules out any dual-pricing scheme in which U.S. petrochemical plants would pay more for Mexican feedstock than Mexican plants.

The issue is whether the reforms in Mexican policy can be memorialized. Mexico does not have a dual-pricing policy now, but this would ensure that it does not occur in the future. (The energy clause in the Canadian agreement ensured that this policy would not return.)

The chapters on energy and investment in the FTA with Canada would seem to meet Mexican requirements: the maintenance of sovereignty over the resource and memorialization of past reforms. I do not accept the arguments that it is not possible to do with Mexico what was done with Canada on energy.

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Mr. Ritchie:

One of the major motivations for the Canadian government and, I suspect, for the Mexican government on entering into these negotiations, is the locking-in of acceptable domestic policy for the future. An objection in Canada to the energy provisions was that they ensured that there would never again be another dual-pricing policy. Yet it was the position of the government at that time that this had been a bad program. As a result, the government was entirely happy to make an international commitment that made it even less likely, as governments changed in the future, that there could be a reversion to that policy.

I suspect, from talking to some of our Mexican counterparts, that this is also part of the Mexican motivation. This could lead to the kind of provisions you are talking about, which would not in fact oblige the Mexicans to change any current policies, but would mean that a future government could not change policies in certain ways.

Canadian Participation in North American Free Trade Negotiations

Professor Ronald Wonnacott:

Another important reason for Canada to participate in the negotiations is to ensure that Mexico does not get a better deal than Canada did. Canada will lose its preference in any case in the U.S. market *vis-à-vis* Mexico, regardless of whether the agreement creates a hub-and-spoke or a free trade area. It is important to ensure that Canadian producers do not end up even worse off by being discriminated against.

For example, the Maquiladora program must be dealt with. In any Mexico-U.S. free trade agreement (whether or not Canada is included), Maquiladora producers will continue to benefit from being able to acquire duty-free inputs from the United States. That duty-free treatment is, of course, automatic in a free trade agreement. In fact, this privilege will extend to all producers in Mexico; in this limited sense, "all Mexico will become Maquiladora." However, the present advantage of Maquiladora producers of being able to acquire duty-free imports from third countries such as Japan would have to be dealt with, in the same way that duty drawbacks are ended in a free trade agreement such as the Canada-U.S. FTA, otherwise there would be a distortion of trade and investment as both would be artificially drawn into Mexico.

In general, it is important for Canada to be at the negotiating table to ensure that these and even more obscure items of importance to Canada are dealt with in the negotiations.

Mr. Ritchie:

I agree about the Maquiladora program, but if the Mexicans and the Americans have an interest in doing something on other things, do the Canadians block them or stop them? How?

Professor Ronald Wonnacott:

By convincing the Americans that it is as much in their economic interest as Canada's to deal with this costly distortion in an appropriate way. This could then be made a condition for allowing Mexico free trade. Nor is it in Mexico's long-run interest to try to defend this special privilege at the expense of Canada and the United States. For future negotiations with new FTA partners, it is important to avoid setting a precedent of new members — in future, say, Argentina or Brazil — getting special privileges at the expense of existing members such as Mexico.

While it seems to me that this is the position to take on this issue, I agree that it may well, to some degree, remain a problem.

Professor Weintraub:

I just want to clarify the Maquiladora rules. Are they that any goods can be imported into Mexico in bond by Maquiladora producers?

Professor Ronald Wonnacott:

Yes, including imports from third countries such as Japan; it is the in-bond privilege on these imports that would have to be dealt with.

Professor Paul Wonnacott:

The exception is if these imports are used to produce exports to countries outside of North America. In this case, the in-bond privilege could remain.